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The Essential Role of Private Enterprise in Reducing Poverty
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Thank you for inviting me to speak at the annual participants meeting of the International Finance Corporation (IFC). The purpose of the IFC, as stated in its charter, is "to further economic development by encouraging the growth of productive private enterprise." So I would like to use this speaking opportunity to discuss the role of private enterprise in the Bush Administration's economic development agenda.

To illustrate my points I would like to draw on some examples from the recent trip by Treasury Secretary Paul O'Neill and Bono to Africa. I was part of that trip, which included four countries, Ghana, South Africa, Uganda, and Ethiopia. Much of the press publicity of that trip focused on the visits to schools, hospitals, community projects, and government agencies. We also visited many private firms—small and large, domestic and global. These private firms are playing an important role in reducing poverty and raising incomes in the places we visited. But they represent a tiny fraction of what the private sector could be, what it should be, and what it must be if we are to be successful in reducing poverty in Africa and other regions of the world.

President Bush's economic development agenda includes substantial increases in U.S. government funding for foreign aid for the first time in many years. It insists on ownership and good economic policy by developing country governments. It demands measurable results from the aid provided by the World Bank and other agencies.

To explain the role of private enterprise in this economic development agenda let me first be specific about the problem that we are trying to solve and how we are trying to solve it.

The problem, of course, is that many people and many countries around the world are still very poor. Despite remarkable economic progress in many parts of the world, over 1.3 billion people live on less than $1 a day, and half the world's population lives on less than $2 a day. Many of these poor countries are in Sub-Saharan Africa. But many are also in Asia and Latin America.

Why are these countries so poor? The simple answer is that there is a lack of high-productivity jobs. Productivity is the value of the goods or services that a worker produces per unit of time. High productivity jobs are the source of high wages, high income per capita, and lasting reductions in poverty. If there are only a few high productivity jobs in a country—as in the countries visited by Secretary O'Neill and Bono—then the country is poor. If the number of high productivity jobs in a country is rising, then the country is becoming less poor. If there are already a lot of high productivity jobs—as in the countries of Western Europe, the United States and Japan—then the country is rich. If you want to reduce the number of poor countries then you have no choice but to increase productivity in poor countries.

And this is where private enterprise becomes essential to any successful economic development policy. The role of the private sector is to create higher productivity jobs and thereby raise productivity growth. Productivity may seem like an abstract concept, but if you look, you can see it growing all around you, and you can see it reducing poverty in the countries Secretary O'Neill and Bono visited in Africa.

In Ghana, for example, a U.S. Fortune 500 firm, Affiliated Computer Services (ACS), recently opened an office. That of course is an example of foreign direct investment. So far ACS has created jobs for 900 Ghanaian workers in this new office. The workers produce services. They process insurance forms that are transmitted via satellite from the United States and then sent back via satellite once the forms are completed. The value of the services produced by these workers is much higher than average labor productivity in Ghana. As a result these workers can be paid, and are being paid, many times the average wage in Ghana. They are all earning more than they previously earned so they have more to spend on food, housing, and clothing for themselves and their children or even to save for the future. When I asked a young single female employee what she was doing with her higher wages she said she was investing in Ghanaian Treasury Bills! By creating higher productivity jobs in Africa, ACS is reducing poverty. ACS has similar operations in Guatemala and Mexico employing about 5,500 in total in the three countries.

Of course it is not only global firms like ACS that create higher productivity jobs in Africa. Consider an example of a domestic firm, Mukwano Industries, operating in Uganda. President Museveni made a special request that I visit this fast-growing firm, and I can see why. In the late 1980s Mukwano employed 100 workers and produced one product line—soap. Now it employees over 7,000 workers producing nearly 25 different products from vegetable oils to plastic cups. The firm produces mainly for the Ugandan domestic market, with some exports to Kenya and Tanzania.

On top of all this, the firm is effectively employing over 100,000 farmers in Northern Uganda in the production of vegetable seeds. Formerly these farmers were only doing subsistence farming. Now they are able to raise their standard of living well above subsistence.

I could go on and on—textile firms, fish smokers, small restaurant owners, green coffee processors, cut flower producers, tuna processing and canning firms, small dairy farms. In each case jobs were being produced by the private sector. And the vast majority of these jobs had higher than typical productivity levels, causing average productivity to rise and poverty to fall. Of course examples such as these are only a beginning, a demonstration that much more can happen. Thus far there is far too little productivity growth in Africa. In fact, for the continent as a whole productivity actually fell during the last dozen years with conflict and disease in many areas offsetting the small gains elsewhere. In order to reduce poverty significantly many more high productivity jobs must be created in Africa and other poor regions. Productivity growth must rise significantly. But how?

Broadly speaking productivity depends on two things: the amount of capital (machines, tools, computers) that workers have to work with and the level of technology, including general know-how. The more capital and the more technology, the higher is productivity. So if you want to raise productivity, somehow you have to raise capital or technology. If there were no impediments to the flow and accumulation of capital and technology, then countries or areas that are behind in productivity would have a higher productivity growth rate. Capital would flow to where it is in short supply relative to labor, such as the countries visited on the O'Neill-Bono trip. Similarly, without impediments, technology would spread through education, foreign investment, or even the Internet. For these reasons, poor areas or countries should be catching up to rich areas or countries.

Consider again some more examples from the O'Neill-Bono trip. Consider two green coffee processing firms that we visited in Africa—one in Kampala, Uganda, and one in Addis Abba, Ethiopia—a distance about the same as between New York and Chicago. Both these firms select and sort green coffee coming off the farms and prepare it for export or roasting. The Ethiopian firm had recently installed a new conveyer belt to bring green coffee more efficiently to workers for sorting. That new conveyer belt—a piece of capital with a new technology—substantially increased productivity at that firm. In fact, to illustrate the improvement, the owner of that firm was kind enough to show us how coffee was sorted before he bought and installed the conveyer belt. In contrast, the Ugandan firm had no such conveyer belt. It was still sorting by the old method; productivity was much lower at that firm despite the available technology. In some sense, therefore there was an impediment for the flow of capital and technology.

Historical evidence shows that when there are few impediments to the use and accumulation of capital and technology, there is evidence for "catch up" in productivity. Productivity growth data in states in the United States—where there have been few impediments—shows that states that were relatively poor in the late 19th century, such as Texas and Florida, grew more rapidly in the 20th century than richer states such as New York or California. Historical evidence of catch up exists in the OECD countries. Among the countries that were founding members of the OECD in the 1960s, lower productivity countries have grown more rapidly than higher productivity countries since the 1960s.

Such catch up does not exist for the world as a whole, however, and certainly not for Africa. While some countries that were very poor in the 1960s have grown more rapidly than the rich countries, many other poor countries have grown more slowly. The reason is that there are significant impediments—in the broadest sense—to investment and the adoption of technology in poor countries that are holding private enterprise back. The example of the Ugandan coffee processing plant with the old sorting method is unfortunately the rule rather than the exception.

One can group these impediments into three areas:

Poor governance, including the lack of rule of law or enforceable contracts and the prevalence of corruption, raises the cost of doing business and creates disincentives for the private sector to create high-productivity jobs. For example, it costs $230 to ship cattle from the Sahel area in Burkina Faso to the coast of Ghana compared to only $80 to ship cattle all the way from Europe to the same point. According to International Livestock Research Institute, which I visited in Africa, "numerous checkpoints and bribes" factor into this large cost difference.

Inadequate education impedes the development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to adopt new technologies to increase the productivity of the jobs they do have. The workers in the ACS facility in Ghana had good writing, reading, and computation skills and could thereby use the new computer technology to raise productivity.

Restrictions on economic transactions prevent people from buying or selling goods or capital, or adopting new technologies. Lack of openness to international trade, monopolistic state marketing boards, and excessive regulations and red tape are all examples of restrictions that create disincentives for the private sector to invest and innovate so as to boost productivity. For example, until recently the government of Uganda operated a marketing board, which controlled most of the buying and selling in the Ugandan green coffee market. The marketing board held down the price paid to farmers for their coffee. After the government eliminated the marketing board, income to coffee farmers increased by nearly a factor of four—from 20 percent of the world price to 70 percent of the world price. So even with the drop in world coffee prices in recent years, many coffee farmers have begun to have higher standards of living.

But there are still many similar restrictions in other markets, in other countries, and between countries. Restrictions on imports into developed countries still reduce the opportunities to create jobs in the export sectors of developing countries. And there are also significant barriers to international trade in developing countries. In Uganda, for example, there is a 45 percent tariff on the import of specialty coffee bags needed for shipping more perishable roasted beans. This tariff is a factor in keeping Ugandan firms out of the roasted coffee market.

To deal with these problems, the Bush Administration's economic development agenda calls for a much greater emphasis than in the past on policies that reduce the impediments to the creation of high productivity jobs by the private sector. Countries that follow good economic policies are to receive more aid, and the actual results of the aid are to be quantitatively measured.

Consider, for example, the Millennium Challenge Account. This account would amount to about $5 billion a year, a 50 percent increase over and above the approximately $10 billion in existing U.S. development assistance. The Millennium Challenge Account would channel aid to poor countries that have chosen to adopt good policies that reduce the impediments to increasing productivity growth. To access the account, developing countries must demonstrate strong commitments to (1) "ruling justly"—upholding the rule of law, rooting out corruption, protecting human rights and political freedoms; (2) "investing in people"—education and health care; and (3) "encouraging economic freedom"—open markets, sound fiscal and monetary policies, appropriate regulatory environments, and support for private enterprise. Of course, these are exactly the ways to reduce the three types of impediments I mentioned above.

Another example is President Bush's proposal to increase the U.S. contribution to the next IDA replenishment (IDA-13) and to tie part of the increase to measurable results. Under this proposal, funding would be 18 percent higher than either the IDA-11 or the IDA-12 replenishments in the 1990s. The proposal incorporates an $850 million contribution in the first year, $950 million in the second year, and $1,050 million in the third year. The increases in the second and third years are explicitly linked to measurable results of the aid, such as in improving education. Linking the size of the IDA replenishment to measurable results is a new idea. I am glad to say that it appears to be having a good impact on other areas of the World Bank. Already we are hearing more about a greater focus on measurable results in the World Bank's operations. In fact today there is a conference on this topic at the World Bank where I will be speaking later.

How much of an increase in productivity growth can we expect if the right policies are chosen and if the results of our aid are successful? What might we hold out as a goal? We should, of course, expect that poor countries should have productivity growth rates much higher than countries like the United States. But I think we can be more specific. There is currently a huge gap between the productivity of poor countries and rich countries. That means that there is a gap between the levels of capital per worker and the levels of technology. But those huge capital and technology gaps represent huge opportunities.

The International Livestock Research Institute operating in Ethiopia demonstrated some of those opportunities for us. By breeding Ethiopian cattle with European stock, they found it is possible to increase milk productivity by over 700 percent. And, if adopted on a large scale, that 700 percent increase in productivity could occur in Ethiopia in a short period of time.

Some simple calculations suggests that countries with huge productivity gaps—like the gap between Ghana or Uganda or Ethiopia and the United States—could achieve productivity growth rates of 10 percent per year on a sustainable basis. That is an ambitious goal, and it requires a much greater growth of the private sector than we have at present. But the 700 percent example shows that it could be a reality.

In conclusion, I hope that I have shown how private enterprise is essential to our economic development goals. I realize that many of the examples I have given are of smaller firms or projects, at least when compared to the large-scale infrastructure projects many IFC participants are interested in. Of course, large infrastructure projects are also essential. For example, the Bujagali project—consisting of a 200-megawatt hydropower station in Uganda—is a sorely needed infrastructure project which has been delayed too long already. But a thriving private sector in general—small, medium, and large size firms—is what is needed to attain the productivity goals I have outlined.

What more could be done for the smaller and medium sized private enterprises? Lack of access to credit is key obstacle. In many developing economies, special connections are needed in order to have access to credit from financial institutions. In many countries, governments use the financial sector to channel resources to inefficient state-owned enterprises.

Financial intermediation is often hampered by a lack of credit ratings, high collateral requirements, and underdeveloped financial management skills. For new firms and small- and medium-sized private enterprises, these factors are often compounded by the inherent unwillingness of banks to serve them due to their perceived riskiness and the higher costs of servicing such clients. Inadequate access to credit inhibits productivity growth. New, entrepreneurial firms have a more difficult time starting up and continuing operations. All businesses have less capital to make productivity-enhancing investments.

The IFC is looking for ways to boost such lending in Africa and I commend Peter Woicke and his colleagues for doing so. Ultimately the private enterprise sector will require the development of full-fledged financial markets to thrive in the developing world.